No. 82-1592

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

MELVYN I. WEISS, Custodian for
GARY MICHAEL WEISS, U/NY/UGMA,
Petitioner,

—v.—

TEMPORARY INVESTMENT FUND, INC., PROVIDENT INSTITUTIONAL MANAGEMENT CORPORATION, SHEARSON LOEB RHOADES, INC., RUSSELL W. RITCHIE, ROBERT R. FORTUNE, HENRY M. WATTS, JR., DR. RALPH A. YOUNG, THOMAS S. GATES, and G. WILLING PEPPER,
Respondents.

ON A PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF IN OPPOSITION TO A PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

Is a shareholder's derivative action under Section 36(b) of the Investment Company Act of 1940 exempt from the director demand requirement of Rule 23.1 of the Federal Rules of Civil Procedure?

PARTIES TO THE PROCEEDINGS

Respondent Shearson/American Express Inc., which is listed in the caption and identified in the Petition filed by Melvyn I. Weiss as Shearson Loeb Rhoades, Inc., is a wholly owned subsidiary of American Express, Inc.

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Respondent Shearson/American Express Inc., named herein as Shearson Loeb Rhoades, Inc. (hereinafter referred to as "Shearson" or "Respondent"), submits this brief in opposition to the Petition for a Writ of Certiorari filed by Petitioner Melvyn I. Weiss, custodian for Gary Michael Weiss (hereinafter jointly referred to as "Weiss" or "Petitioner"). Weiss, in

his petition for a writ of certiorari, seeks review of that part of the judgment of the United States Court of Appeals for the Third Circuit entered, on November 12, 1982, (49a-50a),[1] which affirmed an order of the United States District Court for the District of Delaware entered on June 17, 1981, (69a), dismissing petitioner's derivative suit under Section 36(b) of the Investment Company Act of 1940 (the "ICA"), 15 U.S.C. § 80a-35(b), for failure to comply with the demand on the board of directors requirement of Rule 23.1 of the Federal Rules of Civil Procedure.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Third Circuit (per Judge Becker) is dated November 12, 1982, reported at 692 F.2d 928, and reproduced in Petitioner's Appendix at pages la to 29a. The December 30, 1982, decision of the Court of Appeals for the Third Circuit denying petitioner's motion for rehearing *en banc* is reproduced in Petitioner's Appendix at pages 51a to 52a. The June 17, 1981, opinion of Judge Schwartz of the United States District Court for the District of Delaware dismissing the complaint for failure to comply with the director demand requirements of Rule 23.1 of the Federal Rules of Civil Procedure is reported at 516 F. Supp. 665, and is reproduced in Petitioner's Appendix at pages 53a to 68a. The August 27, 1981, district court opinion denying petitioner's motion for reargument and for leave to file a second amended complaint is reported at 520 F. Supp. 1098, and reproduced in Petitioner's Appendix at pages 71a to 75a.

JURISDICTION

The jurisdictional requisites are adequately set forth in the Petition at page 2.

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1 References to Petitioner's Appendix will be made as follows: "Xa-Ya".

STATUTES INVOLVED

Section 36 of the Investment Company Act of 1940, 15 U.S.C. § 80a-35 and Fed. R. Civ. P. 23.1 are set forth in Petitioner's Appendix at pages 79a to 81a.

STATEMENT OF THE CASE

Petitioner Weiss, as custodian for his son, a shareholder in the Temporary Investment Fund, Inc. (the "Fund"), filed this derivative action on behalf of the Fund against the Fund's investment adviser, Provident Institutional Management Corporation ("PIMC") and Shearson, the Fund's underwriter, distributor and administrator, and the Fund's directors, to challenge the Fund's contracts with its adviser and underwriter-distributor. Weiss' complaint alleged, *inter alia*, that defendants had breached their fiduciary duties under Section 36(b) of the ICA by having entered into allegedly excessive and unreasonable fee agreements.

Although the action was initiated derivatively on behalf of the Fund, petitioner conceded in his pleadings that he had made no prior demand on the Fund's board of directors pursuant to the requirements of Fed. R. Civ. P. 23.1. Furthermore, it was uncontested by petitioner that at the time of the filing of the original complaint, four of the Fund's six directors were "disinterested persons" under Section 10(a) of the ICA. 15 U.S.C. § 80a-10(a).[2] Thus, a majority of the Fund's directors, who had approved the challenged advisory and administrative fee agreements, were unaffiliated directors.

Shearson and the other respondents moved to dismiss the complaint on the ground, *inter alia*, of petitioner's deliberate

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2 The statute defines "interested person" to include persons who have close family ties or substantial financial or professional relationships with the investment company or its advisers, or who have legal or beneficial interests in the adviser's or underwriter's securities.

refusal to comply with the Rule 23.1 demand requirement, and the District Court granted the motion. The District Court reasoned that there was nothing either "in the language of Section 36(b)" or in its legislative history which indicated that "Congress intended to eliminate the demand requirement". (58a). The District Court also found that demand was not excused as being futile in this case. The District Court subsequently denied petitioner's motion for leave to make a post-complaint demand upon the Fund's directors and to file a second amended complaint if demand were refused.

On appeal, the United States Court of Appeals for the Third Circuit affirmed, holding that a Section 36(b) action is derivative (15a), and that the legislative history of Section 36(b) "reflects an implicit understanding that Rule 23.1 would apply—an understanding which comports with the purposes of Section 36(b)." (18a). The Third Circuit concluded:

> "In sum, to read the ICA's statutory scheme as depriving directors of the opportunity to respond to a shareholder grievance would undermine the very purpose of the ICA—to strengthen management of the Fund by its independent directors." (27a).

Petitioner's request to the Court of Appeals for the Third Circuit for a rehearing *en banc* was denied.

REASONS FOR DENYING THE WRIT

Petitioner's principal argument in support of the grant of a writ of certiorari to the Third Circuit is that the decision of the Court below is erroneous and conflicts with the rationale of prior decisions of this Court. Contrary to petitioner's assertion, the decision of the Third Circuit is consistent with the rationale of prior decisions of this Court, supporting both the fundamental principle of corporate self-governance embodied in the ICA, and the factors which this Court has held should be considered on the issue of implying a right of action from a Congressional statute.

In enacting the 1970 amendments to the ICA, which included Section 36(b), it was Congress' intent to preserve and strengthen—not weaken as petitioner would have it—the management role of the unaffiliated directors with respect to advisory fees. Thus the Senate Report on Section 36(b) stated:

> "[T]his section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section is not intended to shift the responsibility for managing an investment company in the best interests of its shareholders from the directors of such company to the judiciary."

S. Rep. No. 184, 91st Cong., 1st Sess., *reprinted in* 1970 U.S. Code Cong. & Admin. News 4897, 4902-03; *see also, Burks v. Lasker*, 441 U.S. 471, 485 (1979) ("Congress entrusted to the independent directors of investment companies . . . the primary responsibility for looking after the interests of the funds' shareholders").

Moreover, Congress understood that in order to strengthen the role of the independent directors of investment companies, it was necessary that the protections of Rule 23.1 apply to shareholder initiated actions under Section 36(b). For example, during Congressional hearings on the 1970 amendments to the ICA, then SEC Chairman Hamer Budge testified that a shareholder action under proposed Section 36(b) would not encourage strike suits because "there are adequate safeguards under the Federal Rules of Civil Procedures [sic] and under this bill to prevent unjustified shareholder litigation." *Hearings on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737 Before the Subcomm. of Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess. 201 (1969); *accord, id.* at 860.

The essential safeguard of the management role of the independent directors of investment companies provided by the Federal Rules of Civil Procedure is Rule 23.1, which requires

that intracorporate remedies be exhausted before permitting shareholders to initiate litigation under Section 36(b) of the ICA. Upon receiving a timely demand, the directors can respond, *inter alia*, by negotiating with the recipient of the purportedly excessive advisory fee for a return of the excess fees, and by terminating the advisory agreement if the negotiations prove unsatisfactory.[3] Moreover, as discussed *infra*, the directors can initiate litigation themselves to recover excessive advisory fees.

In short, the ICA imposes a fiduciary duty upon investment advisers not to charge excessive advisory fees, and upon the directors of investment companies to evaluate the propriety of advisory fees. To exempt Section 36(b) actions from the Rule 23.1 director demand requirement would permit a single shareholder of the Fund to bypass unilaterally the directors of the Fund, and require that the duty to police advisory fees be accomplished through expensive, and perhaps unwarranted, litigation rather than through the Fund's board of directors. Such a result would, manifestly, be contrary to the intent of Congress.

Weiss' Petition further erroneously suggests that the Third Circuit's decision erred in "its holding that an investment company has an implied private right of action under section 36(b)." *See* Petition at 10. In *Cort v. Ash*, 422 U.S. 66, 78 (1975) (citations omitted), this Court set forth the factors which must be considered on the issue of a statutory implied right of action:

> "First, is the plaintiff 'one of the class for whose *especial* benefit the statute was enacted,'—that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or im-

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3 The 1970 amendments to the ICA require directors to investigate and evaluate advisory fee contracts, demand that a majority of disinterested directors approve the contracts, and permit the directors to terminate contracts without financial penalty upon sixty days notice. 15 U.S.C. § 80a-15(c).

> plicit, either to create such a remedy or to deny one? Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law?"

In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. ____, 102 S.Ct. 1825 (1982), this Court elaborated upon the *Cort* standards:

> "In determining whether a private cause of action is implicit in a federal statutory scheme when the statute by its terms is silent on that issue, the initial focus must be on the state of the law at the time the legislation was enacted. More precisely, we must examine Congress' perception of the law that it was shaping or reshaping. When Congress enacts new legislation, the question is whether Congress intended to create a private remedy as a supplement to the express enforcement provisions of the statute. When Congress acts in a statutory context in which an implied private remedy has already been recognized by the courts, however, the inquiry logically is different. Congress need not have intended to create a new remedy, since one already existed; the question is whether Congress intended to preserve the preexisting remedy."

Id. at 1839 (footnote omitted). The Third Circuit in this case specifically applied all of these factors.

The Third Circuit found that the first *Cort* factor was satisfied because an investment company was the intended beneficiary of Section 36(b). As petitioner Weiss had conceded to the Court, any recovery obtained in a shareholder suit under that Section reverts to the investment company. (12a). The Third Circuit further concluded from an analysis of the legislative history of the ICA that the second *Cort* factor was met because Congress did not intend to restrict an investment company's preexisting right to sue. Pursuant to the *Curran*

standard, if under the "contemporary legal context" an investment company had a right to sue to recover excessive advisory fees paid, then the Court need only determine whether Congress intended to preserve the existing remedy. (13a). The Third Circuit reasoned that Congress intended to preserve the investment company's right of action because the investment company possessed, and still possesses, a common law cause of action against its investment adviser.[4]

The Third Circuit found that the third and fourth *Cort* factors were also fulfilled because implying a cause of action under Section 36(b) for the investment company fully accords with the purposes of that Section, and does not intrude upon an area of law traditionally relegated to the states. (14a). As a consequence, an investment company such as the Fund does have an implied right of action under Section 36(b) against its investment advisers to recover allegedly excessive advisory fees paid. The Third Circuit, therefore, was correct in concluding, as discussed *supra*, that a demand upon the Fund's board is a necessary prerequisite to a shareholder initiated suit under that Section.

Moreover, even if the Third Circuit's analysis were rejected and an investment company did not itself have a right of action under Section 36(b), a shareholder's action under that provision is still a derivative action, and therefore, must be preceded by a director demand. Since a recovery of monies would be payable only to the Fund, a point conceded by plaintiff when he filed his complaint "derivatively on behalf of the Fund", the Section 36(b) shareholder action is derivative in nature. As this Court stated in *Burks v. Lasker*, *supra*, 441 U.S. at 484, when referring to suits under Section 36(b): "A derivative suit is brought by shareholders to enforce a claim *on behalf of* the corporation". *Id.* at 477 (emphasis added).

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4 This common law predecessor to Section 36(b) was an action brought by the investment company against the investment advisor for "corporate waste", which traditionally has been deemed to be a derivative action. 13 W. Fletcher, *Cyclopedia of the Law of Private Corporations* §§ 5924, 5926, 5927 (rev. perm. ed. 1980).

Furthermore, neither the language nor the policy behind Rule 23.1 supports petitioner's theory that a Section 36(b) action would be derivative only if the right which the shareholder is seeking to enforce on behalf of the corporation is one which the corporation could assert on its own behalf in a lawsuit. As explained *supra*, the directors of an investment company have both the duty and the means to resolve disagreements concerning the propriety of advisory fees in the absence of litigation. Thus, even if the directors of the Fund could not initiate litigation to resolve a shareholder grievance concerning advisory fees, the unaffiliated directors, who are the "independent watchdogs" of the Fund, *Burks v. Lasker, supra*, 441 U.S. at 484, are owed a demand by a shareholder prior to commencing litigation under Section 36(b) in order to give them an opportunity to resolve the problem without litigation. To deny the directors the right to exercise this power would undercut the Congressional effort in the ICA to enhance the role of the unaffiliated directors.

Thus, regardless of whether the board of directors of an investment company can bring an action to enforce the fiduciary duties embodied in Section 36(b), the Third Circuit was correct in holding that such an action must be preceded by the exhaustion of intracorporate remedies in order to strengthen the watchdog role of the independent directors and to avoid needless nuisance litigation.

Turning to petitioner's procedural argument, petitioner contends that this Court should grant certiorari and consolidate this case with *Fox v. Reich & Tang, Inc.*, 692 F.2d 250 (2d Cir. 1982), *cert. granted sub nom. Daily Income Fund, Inc. v. Fox*, ____ U.S. ____ (March 7, 1983), because of a conflict in the circuits. In fact, the position taken by petitioner in this lawsuit, *i.e.*, that Section 36(b) of the ICA is exempt from the director demand requirement of Rule 23.1, was urged upon this Court by the petitioner in *Grossman v. Johnson*, 674 F.2d 115 (1st Cir.), *cert. denied*, 459 U.S. ____, 103 S.Ct. 85 (1982). This Court declined to disturb the result in *Grossman* and petitioner has given this Court no basis to take a different view in this matter.

Moreover, contrary to petitioner's suggestion that this action can be consolidated with the *Fox* case without adding to the burden of this Court, consolidation of these cases for argument would be cumulative and only enlarge the number of brief and record pages which would have to be reviewed without providing this Court with any concomitant benefit. Therefore, the record in this case will not in any material fashion enhance the perspective of this Court beyond that available in the *Fox* record and briefs. Accordingly, petitioner's request for a writ of certiorari should be denied.

CONCLUSION

For the foregoing reasons, Weiss' Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit should be denied.

Respectfully submitted,

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